

Part One

THE BASICS OF INVESTING

The information presented in Part One is what we refer to as the basics of investing. It is a brief overview of the fundamentals of intelligent investment management—an attempt to answer the following questions: What works? What makes sense? What doesn't? And why?

The facts shown in the tables and charts are nothing new. But, hopefully, our interpretation of these facts will give you something new to think about. You may find it gives you a new perspective on investing which shows that the market can be rational. It may even let you see that much of what the media is telling you about the market is simply sensational hype. And knowing this may let you, the investor, sleep better at night.

The first step in understanding investing is to understand money. So in Chapter 1 we talk about money, inflation, and how inflation drives the investing climate. Then we show you how recognizing the investing climate can make you money.

In Chapter 2, we review the three classes of securities: short-term debt, long-term debt, and equities. How do they work? What drives their returns? Where should the intelligent investor put his money?

“The Basics of Investing” is the survivor’s guide to investing. Understanding the basics can help make sense of all the changing, and often conflicting, investing information that surrounds us. I find that if you don’t get too far from the basics, you won’t get tagged too far off base.

Chapter 1

Understanding Money

Adapted from a presentation delivered at the Muhlenkamp & Company Seminar in December 2002. Supporting exhibits are updated through 2006.

In order to understand investing, you must first understand money. In order to understand today's investing markets, you must first understand the past 50 years, which set the background for today's market. The primary driver of major market changes (what we call *climate* changes) during that time has been inflation and what it has done to our money.

Exhibit 1.1 shows three postage stamps from the years 1968, 1978, and 2007; their prices are 6 cents, 13 cents, and 41 cents, respectively. Each stamp has the same value—each represents the cost of mailing a first-class, one-ounce letter in the United States. Each stamp has a different price and a different date. What changed between 1968 and 2007 was not the value of the stamp but the value of the dollar.



Exhibit 1.1 Inflation and The Value of Money

Between 1968 and 1978, the dollar lost half its value. So to get the same value, you had to double the price of the stamp. From 1978 to 2007 the dollar lost more than two-thirds of its value, so the price of a first-class stamp tripled.

Our federal government has standards as to what constitutes a gallon, so no one can cheat you on a gallon of gas. There are standards on the bushel, there are standards on the ton, and there are standards on the yard and the foot, but there are no standards on the value of our money. We run into trouble when we think of the value of the dollar as being fixed, like our other measures. To illustrate my point, imagine what would happen if there was no standard on one of our other measures.

My wife Connie is a seamstress. She buys fabric by the yard. Suppose the fabric store where she buys fabric manages to shrink their yardstick by a quarter-inch each month. A quarter-inch a month, three inches per year, comes to 8 percent per year. (Between 1968 and 1978, inflation was about 8 percent a year.) So my wife starts getting short on fabric. She remeasures the fabric with her own yardstick and concludes that the store is cheating her.

But what if they also manage to shrink *her* yardstick by a quarter-inch per month? Now she swears that I'm growing taller! Using this analogy, by 1968 dollars I'm 39 feet tall! If our yardsticks had shrunk at the same rate as our money, I'd be 39 feet tall in today's measure. The effects of inflation can easily be overlooked because inflation shrinks everyone's yardstick. Over time, the effect of inflation on our money can be tremendous. We can't afford to overlook it.

Exhibit 1.2 plots the Consumer Price Index (CPI), which is the standard measure of inflation, since 1952. Most people, as consumers,

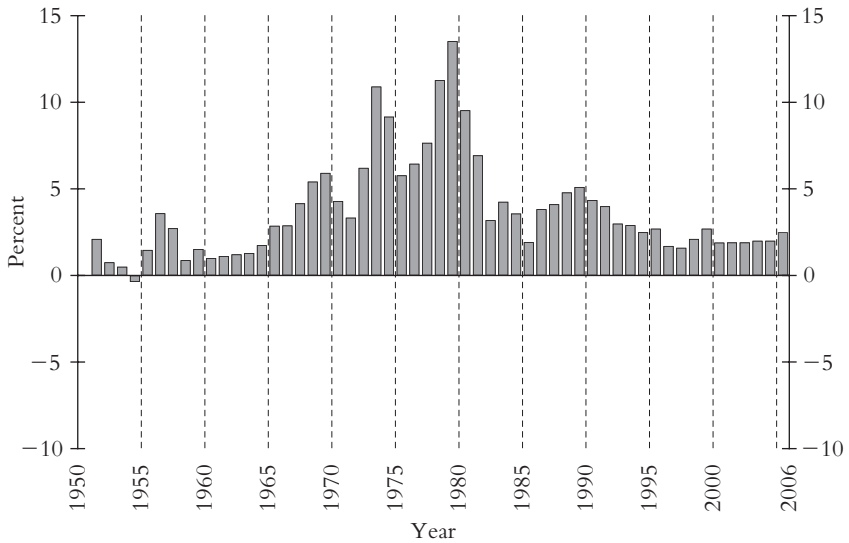


Exhibit 1.2 Inflation, 1952–2006

SOURCE: Bureau of Labor Statistics.

think of inflation as prices moving up—and they’ve moved up by these amounts, year by year, over that 54-year period. As investors, we think of inflation not as prices moving up but as the value of money shrinking, which is shown in Exhibit 1.3. Same information—different perspective.

Your money, whether income or assets, lost value by this rate each year for the past 54 years. Over that period of time, the value of what used to be a dollar shrank to about 15 cents. This is the rate at which our yardstick has been shrinking. If you are talking about investing, everything is measured in dollars, which means it’s measured by this yardstick. The first thing you have to do with those dollars is to adjust them for the shrinking yardstick. Since most people have more experience with real estate (especially homes and mortgages) than with stocks and bonds, let’s talk about real estate assets, and particularly mortgages, to explain what has happened to the value of your money over the past 54 years.

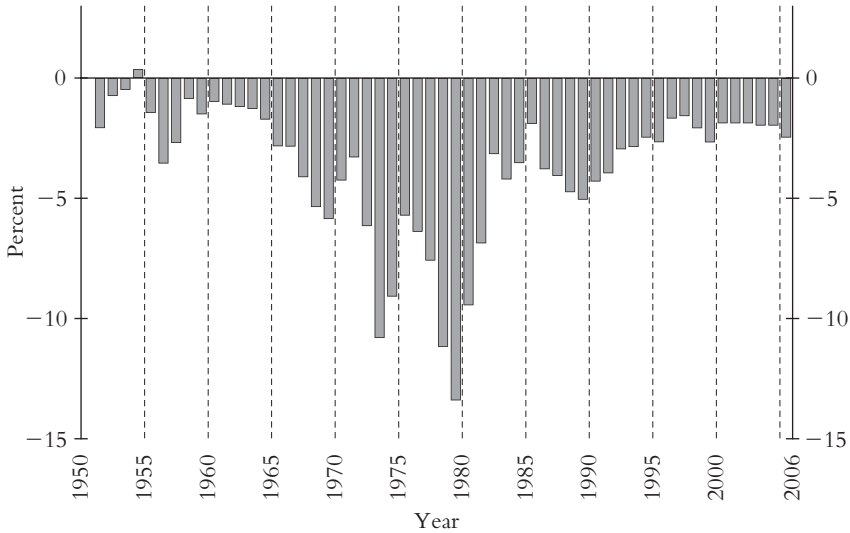


Exhibit 1.3 Inverse Inflation, 1952–2006

Inflation and Mortgage Rates—Understanding Climate Change

Exhibit 1.4 plots the nominal mortgage rate from 1952 to 2006. This is the rate that would have been quoted to you by a bank or a savings and loan organization. In 1951 my father bought a farm and had a 4.5 percent mortgage. All the neighbors said, “Izzy, you’ll go broke in the next depression.” There had been a depression after World War I, and everybody expected another one after World War II. Even though he put 40 percent down and financed the other 60 percent at 4.5 percent, he didn’t eat or sleep for two days because this debt scared him to death. Incidentally, his interest cost him less than it cost to rent a house at that time.

In 1971, my wife Connie and I bought a house with a 7.5 percent mortgage. Dad said, “Ron, that’s awful high.” I said, “All I know is that on an after-tax basis, this mortgage is costing me no more than the apartment we live in.” On a month-to-month basis, after taxes, the cost was the same. That’s all I knew. Fortunately, that’s all I needed to know.

In 1981 my brother Rod bought a house with a 14 percent mortgage. I said, “Rod, that’s high.” He said, “Don’t worry about it. Inflation

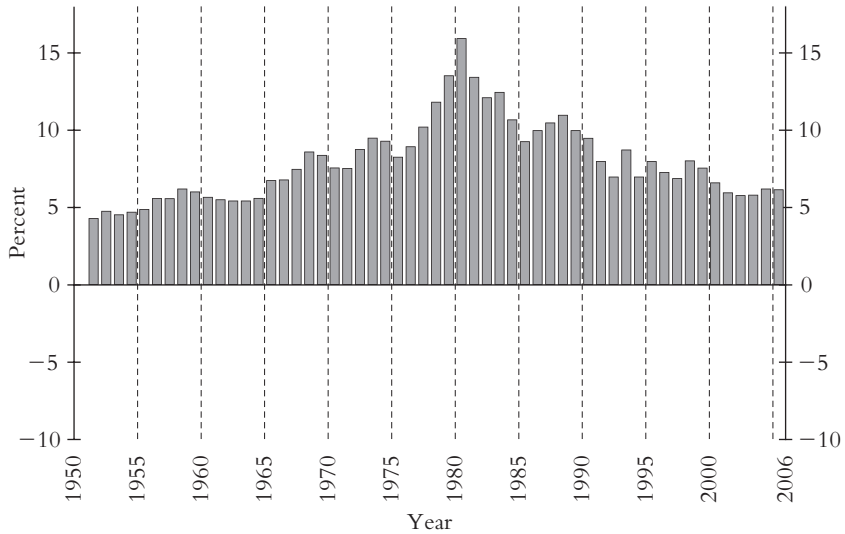


Exhibit 1.4 Nominal Mortgage Rate, 1952–2006

SOURCE: Federal Reserve Bank of St. Louis.

will go up and take care of me. The price of the house will go up. I'm not worried about it." Think about that. My father feared a 4.5 percent mortgage. My brother did not fear a 14 percent mortgage. This is a complete reversal of attitude because of a change in the economic climate.

Exhibit 1.5 is simply the nominal mortgage rate plotted along with the inverse of inflation. At first glance these charts look a whole lot alike. But, in fact, inflation ran up long before mortgage rates. Then, in the 1980s, inflation ran down quickly, and mortgage rates came down gradually.

All through the 1970s people said, "Yes, inflation is up, but it will come back down." All through the 1980s people said, "Yes, inflation is down, but it will go back up." There was a huge lag in perception behind reality. Some folks like to say that Wall Street anticipates the future, six months out. And it does, on some things like earnings. But it was a decade late on changes in inflation—changes in the value of money. Perception of inflation, first up and then down, lagged reality by a decade. Those lags can make you (or cost you) an awful lot of money.

If we net these two charts, we get *real* mortgage rates (nominal rates minus inflation), as shown in Exhibit 1.6.

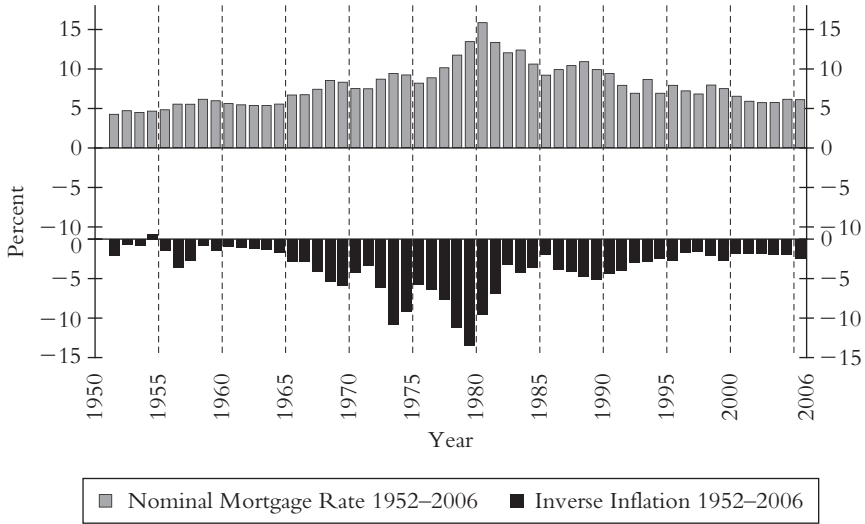


Exhibit 1.5 Nominal Mortgage Rate and Inverse Inflation, 1952–2006

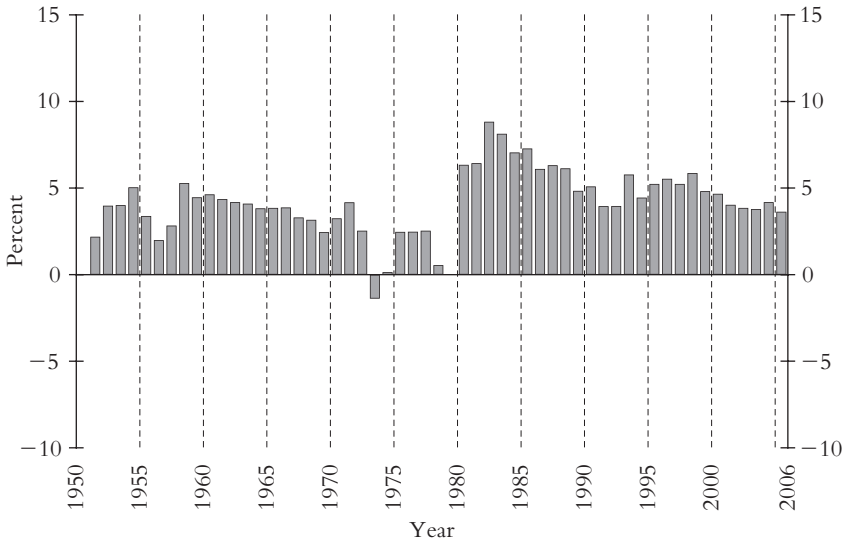


Exhibit 1.6 Real Mortgage Rate, 1952–2006

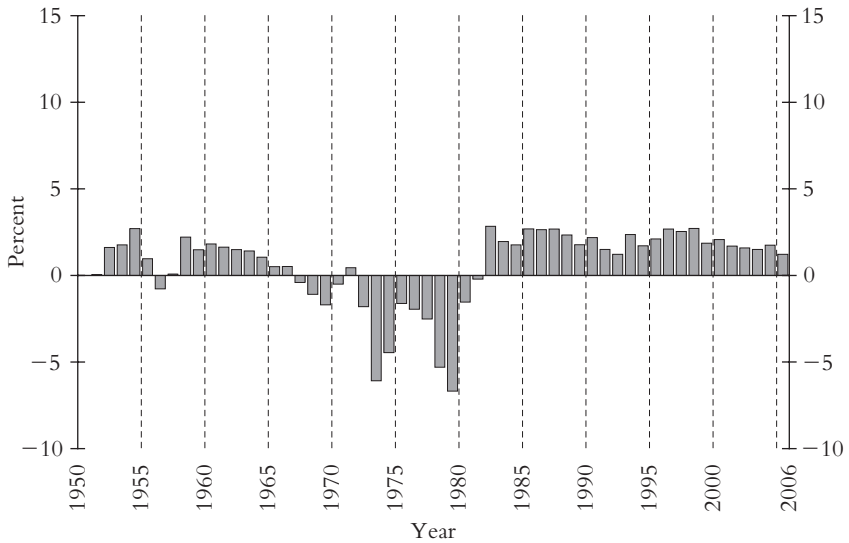


Exhibit 1.7 Real After-Tax Mortgage Rate, 1952–2006

As you know, the interest on mortgages is tax deductible, so if we adjust for taxes, we get Exhibit 1.7.

That looks different, doesn't it? We are seeing three different economic climates:

1. From 1952 to 1967, long-term debt cost you money. My father's 4.5 percent mortgage, after taxes and inflation, was costing 2 percent, so we worked like dogs to pay it off early.
2. From 1968 to 1981, long-term debt actually made you money. Connie and I bought a house in 1971. Within a short period of time, I realized that the last thing I wanted to do was to pay off my mortgage early. My mortgage was making me money! I wish I had bought a bigger house with a bigger mortgage. Remember the phrase, "Trade up on the equity"? From 1968 to 1981, the economic climate made borrowing a winning proposition. Trading up on the equity worked. But the climate changed again.
3. By 1982, borrowing money was once again a liability. My brother's 14 percent mortgage was costing him money. Within a couple of years, he'd rolled it down to 11 percent, still costing him money.

All through the 1980s he was willing to pay 11 percent because he assumed that inflation was going back up. He made this assumption because he thought what he saw in the 1970s was normal. He didn't realize that the economic climate had changed.

When the Climate Changes, It Changes the Rules

Understanding the climate changes illustrated in Exhibit 1.7 is critical to understanding many of the successes and pitfalls of investing for the past 50 years. It is that important. It illustrates why a strategy that works at one time, suddenly doesn't in another. In other words, when the climate changes, it changes the rules. The best thing you and I could do in the 1970s was to borrow money. For most of us, the way to borrow money was to buy real estate. My farmer cousins who bought farmland in the 1970s are millionaires today. Those who started buying farmland in the 1980s went bankrupt.

When the climate changes, when the value of the money changes, it changes everything—certainly everything valued in money. You don't have to predict this, but you do have to recognize it when it happens.